Monthly Labor Review

June 2019

To cut or not to cut?

Yavor Ivanchev

Economists have found that firms seeking to reduce labor costs during tough economic times are more likely to lay off workers than to cut their pay. So far, however, the factors responsible for this “pay rigidity” remain unclear, and so does their relative importance in influencing management decisions about employee retention and compensation. In a recent article, “Analyzing the aftermath of a compensation reduction” (National Bureau of Economic Research, October 2018), Jason Sandvik, Richard Saouma, Nathan Seegert, and Christopher Stanton take on these questions, offering direct evidence in support of a turnover-based account of why firms may be averse to reducing worker compensation.

Using insights from previous research, the authors identify two possible explanations of pay rigidity. The first, which finds indirect support in management surveys, suggests that pay cuts could compel workers who are more productive to leave a firm, thus degrading its workforce quality and economic performance. The second possibility, consistent with recent short-term laboratory experiments, posits that pay reductions could suppress worker effort, thus lowering overall firm output. In either case, adverse attrition or worker productivity responses could make a firm’s adoption of pay cuts a self-defeating strategy in weathering poor market conditions.

To assess these claims with direct, real-world evidence, Sandvik and colleagues use data from a large digital-sales firm whose workers are compensated through a mixture of fixed wages and commissions. Taking advantage of the firm’s past decision to cut commissions in two of its divisions by 18 percent, the authors carry out a longitudinal analysis, examining how workers with different productivity (measured with revenue per sales call and availability to answer calls) responded to the pay reduction. In addition, the authors examine how these responses varied by pre-reduction employee attitudes (captured through surveys predating the drop in compensation) about firm fairness and career prospects.

The results from these analyses show a strong and heterogeneous turnover response but a weak performance response. Turnover increased by nearly 50 percent among top performers and stayed about the same among those at the mean, a difference that altered the quality composition of the workforce and led to a significant drop in firm output over the months after the pay cut. By contrast, the level of employee effort budged little, and turnover and productivity responses did not differ systematically across employees who held different attitudes toward the firm before their commissions were slashed. According to the authors, these findings favor the turnover explanation of pay rigidity, suggesting that many managers may be averse to cutting worker pay out of fear that doing so would backfire by forcing their best performers to find jobs elsewhere.